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Economic Conditions
Governmental Finance
United States Securities

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General Business Conditions

THE new year has opened quietly, so far as orders and operations in the major industries are concerned. To those who looked for a quick pickup after the holiday and inventory period the reports have been disappointing. However, the weight of experienced opinion at the year-end was to the effect that a leveling off was to be expected after seven months of uninterrupted rise, and business sentiment has been prepared for a period of marking time and minor adjustments. The check has been sufficient to cause a drop in the Federal Reserve index of industrial production, which according to preliminary figures will show for January the first month-to-month decline since last May; but the loss is chiefly due to seasonal adjustment. Even though the aggregate industrial output during the month has been about the same as in December, the failure to make the usual January advance represents a setback.

The decline in stock prices to the lowest level since the European crisis last September may be interpreted as part of the general hesitation, and of course one of the reasons for it is the evidence that tension is spreading again in Europe, with the chief point of strain now in the Mediterranean. All analyses of the 1939 business prospects have emphasized the importance of unpredictable events abroad, the trade disruption and exchange unsettlement growing out of them, and the danger of shock and disturbance in this country.

During the past month the British authorities, who in December had reimposed the ban on offerings of foreign security issues in the London market, have taken further steps to protect the pound sterling. Advances against gold and other currencies have again been prohibited, and bankers are now required to limit forward operations in sterling to "normal trade requirements." Loans against foreign securities are not restricted if in "the normal way of business," but are not permitted if they represent speculation against sterling. This may have the effect of reducing British purchases of American securities.

This country, like all other countries, will benefit far more from stability in the pound sterling than it can possibly lose by a reduction of British buying in our security markets; and the foreign money which is moving to the United States unquestionably would contribute more to economic recovery if it were put to work at home or in other countries where it is more needed. Nevertheless, efforts to confine money in any place will not necessarily make it go to work there. The fact that Great Britain, like many lesser countries, is having to discourage purchases abroad, even to this limited extent, because of the exchange problem, is another symptom of the disorder in world relations. This disorder affects everyone who has or makes anything to sell abroad, which includes farmers and factory workers as well as security holders.

Commodity Markets Sluggish

The sluggishness in the markets for basic commodities continues to be one of the important elements in the business situation. The recovery in business in this country produced in its early stages a rise in prices of industrial raw materials, ranging from 20 to 50 per cent in most staples; but despite the fact that production expanded until December the price improvement in almost all commodities was checked by October, in foodstuffs as early as August.

In the domestic situation this check is evidence that buyers are adequately supplied, and also of the fact that business men cannot see as far ahead as they would like; even though their expectations may be fairly optimistic they are taking no unnecessary risks in their buying. This is a reasonable and practical policy, in view of the abundant supplies of most commodities, and it is keeping the situation free of the dangers of over-expanded inventories and commitments. However, it is also one of the factors in the leveling off of production, since the shortening up of commitments, following the forward buying in the Summer and early Fall, has required curtailment in some instances

to get the markets in order. This is the case in steel, and also in copper.

In the international situation the effect of the price check is that the purchasing power of the raw material producing countries is not increasing as much as would be desirable from the standpoint of world trade and exchange stability. The London Economist, in its "New Year Survey," suggests that the disappointing course of prices is partly the result of smaller purchases by Great Britain and other industrial countries, and sees evidence in this that the difficulties in the situation go "rather deeper than its purely American aspect." It concludes that the measures taken by a number of countries to restore equilibrium in their balances of payments make it "rash to look for any sustained increase in British exports . . . unless the further progress of American recovery pushes commodity prices upward."

What affects the British export outlook affects ours also. It is reassuring, however, to consider that we are now buying more imported materials, and paying better prices for them, than we were in the Spring of 1938. Moreover, expansion of imports comes more slowly in the first stages of recovery, when stocks on hand are usually large, than later. Further recovery would require an increase in our imports of hides, wool, tin and some other commodities. Hence pessimism may be premature.

It is pertinent to add two more sentences from the Economist's survey, constituting its summary of the British prospect:

> For the early months of the year, the indications seem to point to a decline in activity and an increase in unemployment, the influence neither of revival in America nor of mounting defence borrowing being strong enough to offset the cumulative forces of the trade cycle. From the summer onwards, however, either factor may begin to exert a stronger influence, and it is fully possible that the two in combination may succeed in pushing the indices upwards.

The emphasis put upon the American situation is striking in a month when the tendency here has been to put great emphasis on the European situation. In fact, both situations will interact upon each other, and war would nullify all prophecies that can be made about either.

Nature of the "Leveling Off"

In the United States the "cumulative forces of the trade cycle" should be towards recovery. The leveling off of production shown by the current figures is the result of mixed causes, none out of the ordinary when it is considered that industrial output rose 37 per cent between May and December, according to the Federal Reserve index. One cause is that production during the depression dropped well below the level of consumption; the rise was rapid while the gap was being filled, but has flattened out as it caught up to current requirements. Another is that the early demand included inventory replenishment, and led to a temporary stepping up of output beyond current consumption needs. Neither of these, in the normal business cycle, would signify more than a halt or a period of consolidation in the recovery. There is no natural limit to consumption except the limit of full employment of labor and productive capacity, from which buying power is derived. Although specific industries reach apparent limits earlier, due to lack of balance or interferences in the upswing, the normal tendency is for recovery to spread.

As for new maladjustments arising during the seven months' rise, they are evidently capable of quick correction. This Letter last month listed various signs that business was not over-extended, namely, the absence of speculative buying and over-commitments in the commodity markets, the conversion of inventories into cash during the past year and a half, the fact that business debt has not expanded, and others. Reference has been made to copper and steel as examples where curtailment has been put into effect. Stocks of refined copper in producers' hands began to rise during November, after having fallen since May; and evidence began to accumulate that crude production, which was 71,795 tons in December, had risen above the final consumption of copper, as represented by shipments of fabricated products. But the discrepancy is not large. There is good authority for estimating final domestic consumption in December at 55,000 tons, which with exports of 9,000 gives a total use of 64,000, indicating that a curtailment of 10 per cent would have kept the situation in balance. All the principal producers have now reduced mining operations. Meanwhile fabricators since the middle of October have bought much less than they used, in fact less than at the bottom of the depression. Domestic sales in the past three months have averaged only 15,000 tons, signifying a substantial cut in fabricators' stocks. This position will require no great depression to correct.

The steel industry has dropped its ingot production in January to an average of about 51 per cent of capacity, against 62 and 53 in November and December, respectively. The lessened flow of orders reflects chiefly the drop in takings of rolled products, following the heavy orders placed at cut prices in October, against which shipments were made before the end of the year. However, the disparity between present production and orders is not great, and the outlook for better buying later is reasonably good. Mr. Grace in reporting the Bethlehem Steel Corporation's earnings said the Corporation was running at 51 per cent, and that orders were at the rate of 46 per cent. He expected a 50 per cent average to be maintained during the quarter. Some observers think the industry will do better than that, with good structural orders, improved

tinplate operations, somewhat better railroad buying, and more sheet business later when the Spring requirements of the automobile industry are met.

The Inventory Situation

The annual reports of corporations, which are now coming out, will be examined with particular interest for information as to inventories, in view of the memories of 1937 and the lack of exact facts from other sources. Thus far the available reports are too fragmentary to warrant broad conclusions. They cover different fiscal years, ending Oct. 31, Nov. 30 and Dec, 31, and they are not a representative cross-section of the major industries. Despite these limitations, however, the figures deserve attention, and a tabulation is given herewith. It shows that the inventories of 100 leading corporations (all having inventories of a million dollars or more) were 10 per cent smaller than a year earlier. This includes four tobacco companies, whose figures are swollen by two consecutive large tobacco crops. Excluding these companies the decrease is 15 per cent.

The quarterly peak of inventories was reached, according to studies made by R.F.C. statisticians, on Sept. 30, 1937. The reduction from the peak accordingly would be somewhat larger than 15 per cent. In the ratio to sales and production, the inventory improvement is of course substantially greater than that shown by the actual figures. Broader conclusions, however, should await more comprehensive tabulations.

Inventories of Leading Corporations, 1937-38
(In Thousands of Dollars)

No.	Manufacturing	End of Fiscal Year 1937	1938	Percent Change
10	Food products	$ 316,790	$269,927	—15
4	Tobacco products....	285,740	295,433	+ 3
10	Textile mill products	20,740	19,262	— 7
7	Clothing and apparel	17,184	11,491	—33
13	Leather and shoes....	90,133	73,049	—19
5	Rubber products	64,616	50,100	—22
7	Paper products	20,647	18,714	— 9
6	Chemical products..	27,763	24,745	—11
22	Metal products........	109,458	102,900	— 6
9	Misc. manufacturing	22,439	18,761	—16
93	Total mfg.	975,510	884,382	— 9
	Trade			
1	Retail	3,010	2,743	— 9
6	Wholesale	25,990	21,306	—18
7	Total trade	29,000	24,049	—17
100	Total mfg. & trade	1,004,510	908,431	—10
96	Total excl. tobacco	718,770	612,998	—15

Other Factors in the Outlook

The foregoing are indications that the conditions which ordinarily precede a substantial slump are not generally evident. There are also stimulating factors, including the government spending; the good building outlook; a satisfactory retail trade prospect; and favorable reports from the automobile industry. The building figures reached the highest level in nearly nine years in December, when daily contracts awarded averaged 86 per cent larger than a year earlier. The chief gain was in the P.W.A. contracts placed to meet the December 31 deadline. However, private awards were up 19 per cent. For the first three weeks of January awards were lower, but the decline in private contracts was less than seasonal and the total shows the satisfactory gain of 27 per cent over the January, 1938, figure.

Automobile sales at retail in the first three weeks of January appear to have shown no more than the usual seasonal drop from the December peak, and the gain over the previous year was 35 per cent or better. As dealers' stocks at the beginning of the year were low, assemblies during the month have been a little higher than expected.

Some business upswings of the past have come to grief on rising living costs. The situation in that respect is not threatening. The National Industrial Conference Board's index of the cost of living is 3 per cent lower than last year, and payrolls, including relief, are higher. The Department of Agriculture estimates that farm income in 1939 will be larger than in 1938. Retailers are expecting to do more business this Spring than last, although their goods are priced lower, and despite their conservative buying policies the openings of Spring merchandise have been successful. The number of buyers in the market in some places has broken records, and their purchases have been ahead of last year. There is little thought, however, of opening Fall lines early.

These are all reasons for believing that the situation will be in good order when outdoor work opens up more generally, the Spring automobile selling season arrives, and government disbursements reach their peak. On the other hand, the capital markets are void of new money issues, and the nearby prospect for resumption of flotations is poor. Moreover, business management is reluctant to spend cash on hand on new plants or projects, chiefly because it does not know whether the business improvement will last beyond the peak of government spending.

Nevertheless, a gain has been noted in machine tool buying, in orders for railway material, and in some other divisions of the capital goods industries. This is the effect of improving earnings, higher levels of operation, and the constant need to modernize plant to reduce costs. The long-term trend of general business activity will depend upon the volume of private investment, as discussed in the subsequent article on the Government's fiscal policy.

Money and Banking

The banking statistics for January reveal the customary increase of money market funds attendant upon seasonal redeposits of currency after the Christmas holidays. During the five weeks ended January 25, money in circulation declined $320,000,000. With gold stocks up

$186,000,000, and with the Treasury drawing on its cash balances in the Reserve Banks to meet current obligations, excess reserves of member banks rose over $600,000,000 to a new peak of $3,600,000,000, approximately $100,000,000 above the "high" of last December.

Nor is there yet reason to suppose that excess reserves have reached a limit. The seasonal reduction in currency has probably run its course, but the inflow of gold continues and, together with the high rate of Treasury spending, seems likely to add further to excess reserves, although a temporary reduction over the month-end is probable. On January 25, it is worthy of note, the Treasury had spendable cash balances in the Reserve Banks amounting to $767,000,000, and in addition held over $600,000,000 of "free" gold available for conversion into Federal Reserve funds at a moment's notice.

Notwithstanding official notice by the Reserve Board in December that Treasury bills maturing in the System's portfolio might not be replaced at times when market conditions made it difficult to acquire bills, no change occurred in the System's total holdings of Government securities during the month. This was in spite of the fact that the successive issues of Treasury bills were sold at prices netting little or no return to buyers. The Reserve Banks did indeed reduce their holdings of Treasury bills during the period, but at the same time increased their holdings of notes to make up the difference.

Gold and Foreign Exchange

Probably the most significant of financial indicators during the month, however, was the evidence of continuing European tension supplied by the foreign exchange markets. Although pressure upon the pound sterling lightened materially, with the rate steadying around $4.67½, following the adoption by the British Government of a series of supporting measures,* including the transfer of £200,000,000 of gold (old valuation, equivalent to $1,647,000,000) from the Bank of England to the Exchange Equalization Account, nevertheless there was indication in the gold movement of a continued transfer of capital to this country from London. For the month of January, preliminary figures show gold imports to the United States from Great Britain amounting to $55,000,000, a reduction, to be sure, compared with the December total of $102,000,000 and with the much larger totals of the crisis months of last Fall, but still an important sum.

More indicative perhaps of the state of uncertainty prevailing abroad was fresh pressure upon the Dutch guilder late in the month, causing a decline in the rate of about ¾ of a cent to 53.62 cents, the lowest in over two years save for one day during the September crisis. For some time there has been evidence that the Dutch authorities have been moving gold out of the country and building up a reserve at more distant points. Since last November the Netherlands Bank has been prohibited from publishing figures of its gold held abroad, and statistics of Dutch imports and exports of gold are also no longer available. However, it has been reported that Dutch gold under earmark abroad — chiefly in the United States — now amounts to about a fourth of the present Dutch gold stock of 1,461,000,000 guilders (about $1,008,000,000). In the last five months, imports of gold into the United States from Holland have approximated $190,000,000.

It may be added that this action by the Dutch Government in redistributing its gold holdings is in line with similar action taken by other European governments during the past year. Belgium last year shipped nearly $350,000,000 of gold to London, and both the British and Swedish Governments are understood to have shifted a portion of their reserves to this side of the Atlantic.

In contrast with the general tendency in the exchange markets, the French franc has held firm in the face of European uncertainties, and a considerable repatriation of capital is reported to have taken place. The improvement in the French situation dates from the outcome of the attempted general strike last November and the promulgation by the present Government of the decree law, modifying earlier legislation, including the 40-hour week law, in a manner to permit increased production. During this interval the franc strengthened from a low of 2.58-13/16 cents to around 2.64⅜ cents at this writing, and industrial activity has experienced a noticeable stimulation. Reflecting reviving French confidence, the French Equalization Fund is said to have recovered nearly 17,000,000,000 francs ($450,000,000) of foreign exchange during the last two months of 1938. While this represents but a small fraction of the total French capital abroad, it made possible a reduction of interest rates in the French market, with a consequent saving to the Government and other borrowers. At the same time, an indication of an improvement in French credit abroad was afforded by the success on the part of the Government in December in negotiating a 175,000,000 guilder loan from Dutch and Swiss banks for the purpose of converting the foreign-held French railway debt to a lower interest basis. In view of the generally threatening aspects of European political developments in January, it is of interest to note Finance Minister Reynaud's assurance in a radio address on the 28th that

*In December the British Treasury reimposed the restrictions on foreign security flotations in London that had been lifted a year ago. This was followed in January by reimposition of the unofficial ban upon loans against gold, forward dealings in gold, and speculative short selling of sterling, that had been relaxed last May.

capital was still returning to France "steadily and regularly".

During the first twenty days of January gold imports into the United States totaled $118,689,000, and preliminary figures indicate further receipts of at least $24,000,000 for the balance of the month. While these figures will undoubtedly be raised in the final tabulation, it is evident that the month's imports fell considerably short of the total of $240,000,000 received in December. Of shipments thus far reported for January, $54,000,000 was from Great Britain, $32,000,000 from Japan and $27,000,000 from Holland. The shipments from Japan represent a return, after several months of diminished volume, to the higher levels of last Summer.

In addition to the foregoing actual receipts, there was at the month-end a substantial quantity of gold en route.

Bank Earning Assets Lower

Total earning assets of the weekly reporting member banks in principal cities declined during January, wiping out the increase occasioned by Treasury financing in December. The decline was caused principally by decreases in holdings of United States Government direct obligations, probably reflecting difficulty in replacing Treasury bill maturities, and by a further reduction in commercial loans. At $3,765,000,000 on January 25, the latter were down $159,000,000 from the disappointingly low Fall "peak" of last year, and more than a billion dollars under the high point of 1937.

Deposits of reporting banks, on the other hand, continued to increase under the influence of gold imports and the Treasury's deficit financing, reaching levels higher than ever before.

With the rise of excess reserves in January, the bond market showed further strength, carrying long-term United States Government issues to new high levels. While a reaction occurred late in the month on fears of adverse foreign developments, most of these losses were subsequently recovered. An offering of $100,000,000 United States Housing Authority 5-year 1⅜ per cent notes was oversubscribed nearly twenty-eight times, affording rather striking evidence of the plethora of funds seeking investment.

Corporate financing in January was the smallest for any month in several years. An increase, chiefly refinancing, is expected in February.

The President's Messages and the Budget

President Roosevelt's three messages to the 76th Congress, delivered early in the present session, have the merit of being so definite in statement that there can be little disagreement as to their meaning. The first of these messages was the usual review of the state of the nation enjoined by the Constitution, beginning with the disturbed conditions in Europe and their possible bearing upon our security. It urged prompt and adequate preparations for any emergency and called for a united democracy; then, turning to fiscal policies, set forth the Administration's views as to the need for increased expenditures, as a prelude to the two following messages — one dealing with the budget proposals and the other asking for a deficiency appropriation of $875,000,000 for relief to the end of the current fiscal year, June 30, next.

With much that the President has said, the nation has shown itself to be in ready agreement. It is clear from the comments upon the message that our people share the President's concern for the peace of the world and are resolved to defend democracy. They welcome the emphasis placed upon recovery, the appeal for cooperation in furthering the common welfare, and the absence of proposals involving difficult readjustments by industry. They are divided, however, in their views as to the effectiveness of government spending as a means for promoting prosperity, and there is growing concern over the rise of the public debt. Evidence of this difference of view is to be found in the discussion between Chairman Eccles of the Federal Reserve Board and Senator Byrd upon the subject of fiscal policy.

The Budget Proposals

The budget message calls for expenditures, excluding sinking fund, of approximately $9,500,000,000 for the current fiscal year ending next June, and for about $9,000,000,000 in the year following. Both sums exceed the previous peacetime maximum of $8,666,000,000 in 1936, the year of the soldiers' bonus. They are considerably more than double the annual rate of expenditures during the decade of the '20s.

Examining the detail of expenditures, given in the table on the next page, it appears that the outlays specifically earmarked for unemployment relief will this year reach a new high total of $2,741,000,000; and next year are estimated at approximately $2,000,000,000. Expenditures for national defense, which have been increasing steadily since 1934, will exceed $1,000,000,000 this year, and for 1940 are budgeted for a further increase to $1,336,000,000. On this basis, the sums spent for national defense in 1940 will have doubled in five years.

As to revenues, it will be seen that the President expects approximately $5,500,000,000 in 1939 and somewhat less than $5,700,000,000 in 1940. Balancing estimated revenues against estimated expenditures leaves indicated net deficits, excluding sinking fund, of $3,972,000,000 in 1939 and $3,326,000,000 in 1940, or more than $7,000,000,000 for the two years combined. In consequence of these continuing deficits, the gross public debt is expected to rise by June 30, 1940 to $44,458,000,000, which is nearly 70 per cent above the maximum debt in-

United States Government Receipts, Expenditures and Public Debt. Fiscal Years Ended June 30, 1931-40
(In Millions of Dollars)

	Estimated		Actual							
RECEIPTS	1940	1939	1938	1937	1936	1935	1934	1933	1932	1931
Income tax	$ 1,903	$ 2,086	$ 2,635	$ 2,158	$ 1,427	$ 1,099	$ 818	$ 746	$ 1,057	$ 1,860
Miscel. internal revenue	2,339	2,179	2,286	2,187	2,009	1,657	1,470	858	504	570
Social security taxes	686	611	604	252	......	......	......	......	......	......
Railroad retirement taxes	124	109	150	......	......	......	......	......	......	......
Processing taxes	......	......	......	......	77	521	353	......	......	......
Customs	404	335	359	486	387	343	313	251	328	377
Miscellaneous receipts	213	200	208	211	216	180	162	225	117	383
Total receipts	5,669	5,520	6,242	5,294	4,116	3,800	3,116	2,080	2,006	3,190
EXPENDITURES										
Ordinary Expenditures										
Legis., judicial & civil	865	799	712	689	675	562	458	584	756	647
National defense	1,126	1,017	980	895	880	663	494	633	664	667
Veterans' pensions, etc.	539	540	572	1,128	2,348	604	554	849	973	943
Interest on the public debt	1,050	976	926	866	749	821	757	689	599	612
Agricult'al Adjust. Program	694	703	362	527	533	712	289	......	......	......
Social security	928	833	678	448	28	......	......	......	......	......
Railroad retirement	127	112	145	6	......	......	......	......	......	......
Other (a)	158	141	271	104	96	95	99	96	171	118
Supplemental items	50	130	......	......	......	......	......	......	......	......
Total ordinary expend.	5,537	5,251	4,646	4,663	5,309	3,457	2,651	2,851	3,163	2,987
Extraordinary Expenditures										
Supplemental item: — New national defense program	210	......	......	......	......	......	......	......	......	......
Public works	1,044	1,229	880	1,102	914	766	625	472	499	421
Unemployment relief:										
Direct relief	42	97	154	184	588	1,916	716	351	......	......
Work relief (W.P.A., etc.)	7	1,604	1,516	1,957	1,298	11	805	......	......	......
Civilian Cons. Corps	285	290	326	386	486	436	332	9	......	......
Supplemental items	1,685	750	......	......	......	......	......	......	......	......
Loans, subscriptions to stock, etc. (net)	120	271	104	150	71	424	882	181	873	263
Supplemental item	65	......	......	......	......	......	......	......	......	......
Total extraordinary expend.	3,458	4,241	2,980	3,779	3,357	3,553	3,360	1,013	1,372	684
Total expenditures, excluding debt retirement	8,995	9,492	7,626	8,442	8,666	7,010	6,011	3,864	4,535	3,671
Debt retirement	100	100	65	104	403	574	360	462	413	440
Total expenditures	9,095	9,592	7,691	8,546	9,069	7,584	6,371	4,326	4,948	4,111
Gross deficit	3,426	4,072	1,450	3,252	4,953	3,784	3,255	2,246	2,942	921
Less debt retirement	100	100	65	104	403	574	360	462	413	440
Net deficit	3,326	3,972	1,384	3,148	4,550	3,210	2,895	1,784	2,529	481
Gross public debt June 30(b)	$44,458	$41,132	$37,165	$36,425	$33,778	$28,701	$27,053	$22,539	$19,487	$16,801

Source: Compiled from President's Budget Message of January 3, 1939 and annual reports of the Secretary of the Treasury. a—Includes refunds of receipts. Government employes' retirement funds, Commodity Credit Corporation losses, settlement of war claims, etc. b—Not including guaranteed debt of government credit agencies.

curred by the war and an increase of over $28,000,000,000 from the post-war low of 1930. It approaches the statutory debt limit of $45,-000,000,000, and does not of course include the guaranteed debt now over $5,000,000,000.

Expressing the view that either sharp curtailment of expenses or drastic increase of taxes would be unwise at this stage of recovery, the President recommends tax increases amounting to nearly $500,000,000, which, if enacted, would tend to modify the foregoing figures to that extent.

Spending to Raise the National Income

Of even greater interest than the budget figures themselves is the suggestion in the President's messages of a new philosophy of government finance, essentially different from anything suggested by him in previous messages, or ever embodied in a political platform or creed in this country. Up to this time deficits have been accepted as necessary evils to be overcome as rapidly as possible. While the President in his earlier messages has advocated government spending as a means for promoting recovery, emphasis heretofore has been laid upon the temporary and emergency nature of such spending. In the program now proposed, the significant feature is an apparent departure from these earlier principles, and an acceptance of the doctrine of spending in order to raise the national income to some given objective—in this case at least $80,000,000,000.

The President says:

> **The object is to put capital — private as well as public — to work. We want to get enough capital and labor at work to give us a total turnover of business, a total national income of at least eighty billion dollars a year. At that figure we shall have a substantial reduction of unemployment; and the Federal revenues will be sufficient to balance the current level of cash expenditures on the basis of the existing tax structure. That figure can be attained within the framework of our traditional profit system.**

The President goes on to say that the "factors in attaining and maintaining that amount

of national income are many and complicated," but urges that the maintenance of large-scale government spending is an essential part of the process. He describes two separate approaches to the problem of recovery, one—the way of economy and a balanced budget—involving an acceptance of the idea that

. . . because our national income this year is only sixty billion dollars, ours is only a sixty-billion-dollar country; that government must treat it as such; and that without the help of government, it may some day, somehow, happen to become an eighty-billion-dollar country.

The alternative approach, involving a continuance of government spending, he enlarges upon as follows:

The other approach to the question of government spending takes the position that this nation ought not to be and need not be only a sixty-billion-dollar nation; that at this moment it has the men and the resources sufficient to make it at least an eighty-billion-dollar nation.

This school of thought does not believe that it can become an eighty-billion-dollar nation in the near future if government cuts down its operations by one-third. It is convinced that if we were to try it, we would invite disaster — that we would not long remain even a sixty-billion-dollar nation. There are many complicated factors with which we have to deal, but we have learned that it is unsafe to make abrupt reductions at any time in our net expenditure program. . . .

If government activities are fully maintained, there is good prospect of our becoming an eighty-billion-dollar country in a very short time. With such a national income, present tax laws will yield enough each year to balance each year's expenses.

In its essence this is the pump-priming principle in new raiment and carried considerably farther than heretofore.

The Theory of "Pump-Priming"

The theory of "pump-priming," as advocated by a certain school of economists, has often been explained in these columns. Briefly stated, it is that when private spending is reduced and purchasing power low, the Government should borrow and spend; this in due course will lead to a resumption of private spending, first mainly for consumption goods, but later spreading into capital goods as manufacturers find the increased demand for their products calling for enlarged plant facilities and improvement in equipment. In this way, according to the theory, a self-sustaining recovery can be generated; whereupon the Government support is withdrawn.

The experience of the past few years has appeared to confirm this theory—up to a point. We have seen a considerable recovery coincident with government spending, affording presumption that the spending has been a factor. Other factors, however, have also been influential and there is room for debate as to the responsibility of each. Certain general questions should be raised and carefully considered.

First, experience raises the question whether it is possible to reduce expenditures at the right moment, or even to check their rise once the people get a taste of the flow of funds from the public Treasury. In public as in private life it is easier to increase expenditures than to reduce them. Although the theory of "pump-priming" implies that government borrowing and spending should subside as private borrowing and spending revive, practically, under actual conditions in which politics become a factor, this theory is extremely difficult to carry out. Witness, for example, the experience in 1936, when, with business recovering, the deficit, instead of declining, rose by reason of the soldiers' bonus to a new peak since the war, probably contributing in no small degree to the wave of over-buying that preceded the 1937 collapse.

Then there is the question whether the stimulating effects of government expenditures do not diminish with each dose. Like stimulants generally, more and more is required to produce less and less. There is evidence to support this conclusion, not only in our own depression and in recent experience in France, but also in repeated instances of the use of inflationary devices throughout history.

Even with respect to the more immediate results of government spending, the extent and nature of influence exerted is largely a matter of conjecture. Certainly, in some measure, distrust created by large public deficits offsets the direct effects of spending. Of course, where government spending and lending are in fields competitive with private enterprise, as in some phases of the power program, the effect is definitely to retard private enterprise. But even where business is not directly affected, deficits and increased taxation, actual and prospective, do not create an atmosphere favoring enterprise.

As to the longer term influence of pump-priming towards producing a lasting recovery, the basic question is whether a stimulation of consumption goods spending necessarily leads to a revival of capital goods spending. No doubt some stimulation of capital expenditures may be effected in this way, but great periods of industrial expansion and of development of new products and facilities have not usually come about because of demands created by consumer spending. As was pointed out in one* of the papers presented before the annual meeting of the American Statistical Association in December, the building of the railroads, the creation of the automobile industry, the introduction of the telegraph and telephone, typewriters and electric power, motion pictures and radio, and countless other devices and conveniences that are now part of our daily lives, were not the result of current spending. They happened "because bold and enterprising men

*"The Outlook for Business in 1939" by Leonard P. Ayres, Vice President of the Cleveland Trust Company.

have had faith that future spending could be stimulated into being, and profits could be derived from it."

Evidence by the National Bureau of Economic Research

Evidence bearing upon the problem of spending to induce recovery is contained in a study published last year by the National Bureau of Economic Research under title of "Commodity Flow and Capital Formation." One of the tables presented in this volume shows the amounts spent annually in this country on new producers' durable goods and new privately financed construction for the period 1919 through 1935. The figures follow:

Expenditures for Producers' Durable Goods and for Private Construction*

(In Millions of Dollars)

	Prod. Durable Goods	Business Construction	Residential Construction	Total
1919	$6,234	$2,762	$1,732	$10,728
1920	6,177	3,129	1,493	10,799
1921	3,926	2,186	2,241	8,353
1922	3,848	2,783	3,524	10,155
1923	5,267	3,300	4,422	12,989
1924	4,962	3,513	4,713	13,188
1925	5,287	4,062	5,202	14,551
1926	5,716	4,366	4,757	14,839
1927	5,461	4,477	4,524	14,462
1928	5,852	4,385	4,255	14,492
1929	6,908	4,581	3,010	14,499
1930	5,480	3,800	1,805	11,085
1931	3,536	2,232	1,262	7,030
1932	2,019	1,097	444	3,560
1933	2,051	936	392	3,379
1934	3,024	1,180	458	4,662
1935	3,615	1,461	923	5,999

* Exclusive of expenditures for repairs and maintenance.

Two striking facts are revealed by the table—(1) the tremendous shrinkage in the expenditures for these kinds of wealth, caused by the depression, and (2) the failure of such expenditures to recover markedly during the 1930s, notwithstanding the enormous sums spent by the Government.

This study gives the figures through 1935, and allowing liberally for a further increase of capital goods output and construction in 1936 and early 1937, it is clear that the total remained far short of figures for the years before 1929. Our recovery, in short, has been a lop-sided affair, dependent primarily upon consumption goods buying, but lacking the support of capital goods buying necessary to give balance and permanence.

All this must occasion serious doubts as to the ultimate outcome of a continued reliance upon public spending to restore prosperity. It suggests rather the need for a careful reexamination of the recovery program with a view to determining what is holding enterprise in check, and removing such obstacles wherever possible.

Long-Term Effects of Continued Deficits

In determining upon fiscal policy, it is important to think not only of the immediate effects, but also of some of the long-term consequences of deficit financing. Three may be discussed briefly: — credit expansion, a heavy debt burden, and fiscal unpreparedness for war or other emergencies.

Credit expansion: The inflationary influence of long continued deficit financing arises primarily from its effect upon the banking system. In this connection it is worth while looking at figures of what has been taking place.

U. S. Government Direct Public Debt, and Amount Held by Commercial Banks*

(In Millions of Dollars)

Year Ended June 30	Total Debt Outstanding	Debt Held by Com. Bks.	Annual Change in Debt	Amount Taken by Com. Bks.	Per Cent
1931	$16,801	$ 5,471	+$ 616	+$1,855	100.0+
1932	19,487	5,832	+ 2,686	+ 361	13.4
1933	22,539	7,143	+ 3,052	+ 1,311	42.9
1934	27,053	9,842	+ 4,514	+ 2,699	59.8
1935	28,701	10,470	+ 1,648	+ 628	38.1
1936	33,778	12,515	+ 5,077	+ 2,045	40.3
1937	36,425	11,850	+ 2,647	— 665	0
1938	37,165	11,160	+ 740	— 690	0
1939-E	41,132	....	+ 3,967	....	
1940-E	44,458	....	+ 3,326	....	
8 Yrs. 1930-38			+20,980	+ 7,544	35.9
10 Yrs. 1930-40			+28,273	....	

E—Budget estimate.

*—All insured banks, or all banks in the U. S. exclusive of savings banks.

As the table shows, a considerable portion of the debt increase has been financed by the commercial banks, and hence has resulted in an expansion of credit. To June 30, 1938, out of an aggregate increase of $21,000,000,000 in the debt since 1930, the commercial banks took approximately $7,500,000,000, or more than a third.

The increase of bank credit resulting from government borrowing has raised the total of bank deposits to a higher level than in 1929, despite much smaller business activity. This increase of bank deposits already has been sufficient to accentuate the problem of the control of credit when that problem arises. It is one thing to check an increase in the volume of credit; it is quite another and more difficult undertaking to control the velocity or rate of turnover of credit already created. And, of course, during the time when the Government is actually increasing its debt and is dependent on the banks' buying its bonds, credit control is next to impossible. At the moment credit control seems hardly a live issue, but we may well remind ourselves that only two years ago it was much discussed, and we may be sure that it will again become an active issue.

The debt burden: It is true that although the public debt has greatly increased since 1929, the burden of interest cost has decreased. This, of course, is because of low interest rates which may not always remain low. A rise of interest

rates sometime during the life of these debts seems almost certain to occur, bringing rising interest costs as the Government faces the necessity of replacing its maturing obligations with securities carrying higher coupons. That part of the debt already funded into low coupon obligations will not be affected, but the burden then will fall upon the bond-holders, including the banks, life insurance companies and benevolent and educational endowments, which will face declines in market prices of their holdings.

Moreover, as to the debt burden, we ought also to bear in mind that even at the debt levels and interest costs of 1937, the total of taxes collected by public authorities in this country, including state and local as well as federal, to meet interest and other costs of government amounted to over $12,000,000,000,* or nearly 18 per cent of the national income then estimated at $69,000,000,000, as compared with 19.6 per cent for Great Britain, with its huge war debt, for the same year. And of course even these figures do not tell the whole story, for had taxes been levied to equal the rate of spending, instead of being postponed in part for future collection, the percentage of their total to the national income would have been still greater.

Fiscal unpreparedness: A third long-term effect of continued deficit financing has to do with the problem of preparedness for war or other national emergencies. In modern warfare, preparedness means being strong economically and financially, as well as from a military and naval standpoint. The nation that goes to war with a big debt labors under a handicap from the start. Lacking an adequate reserve of borrowing power, such a country soon runs into difficulty in selling its bonds, and the danger of inflation arises earlier. The United States, in all its wars to date, has had the enormous advantage of starting off with a low debt. We went into the World War, for example, with a debt of less than $1,000,000,000, and now the interest alone on the debt is more than $1,000,000,000 a year.

The Discussion Summarized

Summarizing briefly the discussion to this point, we have reviewed the budget proposals, contemplating as they do the highest rate of federal spending since the war, a continuing heavy deficit and a rise in the public debt to a figure far above any previously known in this country.

We have referred to the new philosophy of government finance, which, instead of regarding public deficits as undesirable but unavoidable consequences of depression, or at most as devices for cushioning deflation or for providing a temporary stimulus to aid business off "dead center," now visualizes them as desirable expedients to be employed until such time as the national income can be raised to some stated objective.

We have discussed the theory of "pump-priming," stating briefly certain grounds for skepticism. These are (a) the difficulty of reducing expenditures at the right moment, (b) the diminishing effectiveness of such stimulants with their use, (c) the distrust created by large public deficits, and (d) the absence of evidence to support the belief that capital goods expenditures follow as a natural sequence of consumption goods expenditures.

We have cited the evidence as to the country's failure in recent years to attain a well-balanced and lasting recovery, notwithstanding huge government expenditures.

And, finally, we have called attention to certain long-term effects of continued deficit financing, to wit — credit expansion, a heavy debt burden, and fiscal unpreparedness for war or other emergencies.

What is to be Done?

All this must inevitably raise the question, what then can we do to help restore prosperity, relieve distress and give real jobs to our ten million men and women who are now unemployed and dependent upon government doles? It is true, as the President has said, that we have the men and resources to achieve a total turnover of goods and services amounting to $80,000,000,000. We had approximately that turnover in 1929, and ought to be able to have it again, even at lower prices, now that the population to produce these goods and services is 7½ per cent larger than it was then.

The President well says that "the factors in attaining and maintaining that amount of national income are many and complicated." However, the way income has been increased in the past has been by working, producing, saving, and applying "capital" to making labor more fruitful. This policy, together with the maintenance of property rights, by which producers and savers were protected in their accumulations, and the latter passed down to succeeding generations, have been the basis of social progress. Gradually, new tools were devised, new materials found, new goods and services offered in trade, and by and by steam-power, railroads, electric power, the telegraph, telephone, automobile, auto-truck and aeroplane became common facilities of intercourse. Every stage of this development has increased the volume of production and trade, or, in other words, the "national income." It should be borne in mind that what is wanted is not a mere writing up of money values, but an increase in the quantity of goods and services exchanged.

Against the theory that government deficits are essential to restore the national income is the record of the years following the war, when

*Computed by National Industrial Conference Board.

we cut federal expenditures from $18,500,000,000 in 1919 to around $3,000,000,000 annually, lowered taxes four times and reduced the federal debt from $26,600,000,000 to $16,000,000,000; and, save for a brief interruption in the year 1921, the national income was steadily rising. From $56,800,000,000 in 1921 it rose to $79,500,000,000 in 1929.

This record was possible because the period was one of great expansion of private enterprise. With faith in the future, business men and investors were eager to go ahead with new ventures, putting people to work and producing new wealth, confident that capital so risked would yield a profit, and that those who took chances and made money would be permitted to retain a reasonable share of their earnings. This was despite disturbed conditions abroad.

Mistakes were indeed made in this period which should not be repeated. Speculation was excessive; credit control was inadequate; there were certain malpractices; but the mainspring for prosperity, enterprise, was operating as it has in every prosperous period in the country's history. This then must be our primary objective, restoration of self-sustaining industry and enterprise, for only in that way can the Government be released of its heavy responsibilities in connection with relief, and the budget brought once more into balance. How to achieve this restoration is a problem upon which opinions naturally will differ in many particulars, but one proposition may be confidently advanced: that the success of a spending program depends largely upon what other things are done while the spending is going on. If the policies pursued both within and without the Government are such as to encourage harmonious relations within the economic system, and give incentive to new undertakings and enterprise, then business should indeed pick up and go ahead. But unless the policies pursued are carried out in this spirit and with these objectives, spending to stimulate business is likely to be effective only so long as it lasts, and leave the situation worse than before, with an added burden of debt and taxes for individuals and business to carry, and other adverse consequences outlined above.

United States Foreign Trade in 1938

The record of the foreign trade of the United States in 1938 has now been completed, with publication of the December returns, and the figures are out of the ordinary in enough respects to merit general attention. If there are people who still believe that the benefits of foreign trade are to be found only in a "favorable" balance, they will consider 1938 a highly satisfactory year, since it produced an export surplus of $1,107,000,000 which is the largest since 1921, or in seventeen years. Export balances began to pile up in the second half of 1937, when the surplus was $403,000,000, making a total for the eighteen months of $1,510,000,000. This is a remarkable reversal from the eighteen months preceding, during which imports exceeded exports.

However, the state of business since the middle of 1937 shows that an excess of exports is no assurance of prosperity. On the contrary, the chief explanation of the trade balance is that our imports of industrial raw materials were sharply curtailed by the decline in industrial activity. Imports of foodstuffs also were cut, chiefly because our own farm production increased. Total imports in 1938 dropped about 29 per cent in volume below 1937, and in value they were 36 per cent lower, totaling $1,950,000,000. Import prices on the average were 10 per cent lower.

At the same time, a combination of circumstances supported exports almost at the 1937 level. In value our 1938 exports totaled $3,057,000,000, a decline of only 8 per cent, and in volume they were equal to 1937. This reflects the fact that the depression elsewhere was slower to develop, and less severe than in this country. Some of the improvement in the purchasing power of the raw material producing countries in 1937 was carried over into 1938, and sales of their products to Europe held up generally better than their sales here. Moreover, the countries which are rearming needed all their output of certain types of goods for their own use, giving the United States an advantage in world markets, and they have themselves been buying from the United States industrial equipment, aircraft, motor vehicles, semi-manufactures of various kinds, and even raw materials such as copper and steel scrap, and foodstuffs to be carried as a war reserve. All these factors have supported our exports for a considerable time after our own buying from other countries dropped off.

Export Surplus Likely to Narrow

This trade balance is impressive. It is unlikely, however, that it will be long maintained. Unfortunately the other side of a favorable balance for this country is an unfavorable balance for others, which has lately found some of them hard-pressed to make payments. The principle is generally understood that exports of goods and services must be paid for by equivalent imports, except as gold may be available to ship or as loans may be extended to the debtor. Thus over any lengthy period it is almost impossible for the rest of the world to buy substantially more from the United States than it sells to us, since its means of payment other than in goods is insufficient.

In the latter part of 1938, the conditions which supported our export trade during the year were showing signs of change. In the first place, the foreign exchange reserves of certain raw material producing countries, built up during the high and active commodity mar-

kets of 1936 and 1937, were steadily being drawn down. Their imports had to be adjusted more nearly to the flow of exports, either by letting their currencies depreciate in the exchange markets, as in South America, or by regulation of imports, as in New Zealand.

Secondly, in industrial countries where domestic activity had been greatest in 1937, manufacturers in 1938 not only caught up on their home deliveries, but a fall in home demand due to business recession released goods for export. The recession in the steel industry in Great Britain is a notable example. Since export markets were contracting, international competition became keener. For the United States competition has stiffened further as a result of the declines of the pound and the franc and of the redoubled efforts of Germany and Japan to secure foreign exchange.

All these developments would have been reflected more in our total export figures, had it not been for the usual seasonal rise in our farm exports during the Fall months. During the three months ending December the exports of practically all non-agricultural products declined.

On the import side, the business improvement here suggests that our purchases abroad will increase, for we need more materials as our industrial activity rises. A rise in imports is in the long run the only way to maintain our exports.

Exports in 1938

The following table gives details of our exports last year:

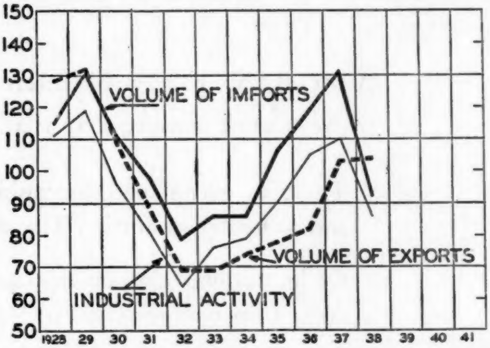
Value of U.S. Exports—Leading Classes & Commodities
(In Millions of Dollars)

	Three Mos. End. Dec. 1937	Three Mos. End. Dec. 1938	Twelve Mos. End. Dec. 1937	Twelve Mos. End. Dec. 1938
Cotton, raw	$129	$ 68	$369	$229
Tobacco, unmfd.	64	63	135	156
Grains & preparations	47	27	94	224
Other agricultural products	66	67	200	219
Copper, ore & mfrs.	22	24	94	87
Machinery, total	127	114	479	486
Metal-working machinery	20	27	64	102
Electrical mchy. & apparat.	30	27	113	102
Agri., well & ref. mchy.	27	21	111	115
Automobiles, parts & acces.	95	71	347	270
Aircraft, parts & acces.	12	15	39	68
Iron & steel, mill prod. & mfrs.	93	58	352	228
Petroleum & related products	98	95	376	389
Chemicals & related products	35	35	139	129
Other non-agricultural prod.	172	153	675	572
Grand Total	960	790	3,299	3,057

Industrial machinery exports are notable in the table, and this was one of our few export items which came up to the 1929 level. Demand last year was particularly heavy for metal working, agricultural, excavating, and road building machinery, for oil well and refining equipment, and for machine tools. The exports of petroleum and derivatives reached the 1929 level in volume, but remained considerably lower in value.

The Revival of Imports

The volume of imports touched the lowest point during the present cycle last May. During the following six months, industrial activity advanced by 37 per cent and the volume of imports gained over 20 per cent, the revival of coffee, hide, silk and sugar imports and lately cocoa, wool and wood pulp, accounting for the bulk of the increase. The following chart illustrates the close relationship between our industrial activity and the volume of our imports during the last eleven years.



U. S. Industrial Activity and the Volume of Foreign Trade (1923-25 = 100)

The failure of the value of imports to advance as much as the volume has been due to the lag of commodity prices. However, increased raw material imports will be necessary to supply our increased industrial activity. It is likely that we shall need more hides, cocoa, wool, tin and rubber, among other materials, than in 1938.

Considering 1938 on a whole, the greatest change in imports took place in those which compete with American farm products. An examination of the accompanying table will show that during the first eleven months we spent for these products less than half the 1937 amount. Grain imports have practically disappeared, those of vegetable oils and seeds are about 47 per cent smaller.

Value of U.S. Imports—Leading Classes & Commodities
(In Millions of Dollars)

	Three Mos. End. Dec. 1937	Three Mos. End. Dec. 1938	Twelve Mos. End. Dec. 1937	Twelve Mos. End. Dec. 1938
Rubber, crude	$ 68	$ 36	$248	$130
Silk, raw	24	28	107	89
Wool, raw	9	10	96	23
Sugar	20	16	166	130
Coffee	35	36	151	138
Cocoa	6	3	52	20
Veg. oils & seeds	29	22	175	93
Grains & preparations	4	3	102	8
Paper base stocks & mfrs.	66	56	255	199
Cotton, wool, jute & flax mfrs.	33	25	162	101
Tin	28	13	104	45
Chemicals, petroleum, etc.	36	33	147	118
All other	285	235	1,245	856
Total	$643	$516	$3,010	$1,950
Agri. competitive (ex-sugar)	95	85	620	295
Agri. non-compet. (incl. sugar)	182	144	869	600

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